2Q2017 PORTFOLIO UPDATE
Steven Bregman

July 19, 2017
An Overview

It’s One Thing to Not Know, It’s Another to Be Told What Isn’t So.

Part I: Unpacking a Mainstream Index, the NASDAQ 100

Part II: Can One Hide From The NASDAQ 100 In The S&P 500?

Part III: Be Outside the System – It’s OK to Earn a Return a Different Way

Appendix: Anniversary Supplement, Right on Schedule: Google + Facebook Versus AOL, 18 Years and Counting
First, the Label

Indexes are intended to avoid company-specific risk, right?

Clearly, this index is the opposite of diversified – its results depend powerfully on individual securities.

<table>
<thead>
<tr>
<th>NASDAQ 100 Top Five Holdings</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAPL Apple Inc.</td>
<td>11.75%</td>
</tr>
<tr>
<td>GOOG, GOOGL Alphabet, Inc. (Google)</td>
<td>8.84%</td>
</tr>
<tr>
<td>MSFT Microsoft Corp.</td>
<td>8.21%</td>
</tr>
<tr>
<td>AMZN Amazon.com Inc.</td>
<td>6.82%</td>
</tr>
<tr>
<td>FB Facebook Inc.</td>
<td>5.42%</td>
</tr>
</tbody>
</table>

**Total Top 5 MV%** 41.04%

Source: PowerShares QQQ
Second, Valuation: When is a P/E Not a P/E?

or How To Turn 90 into 22 in Three Easy Steps

**Harmonic mean** (From Wikipedia, the free encyclopedia)
In mathematics, the harmonic mean...is one of several kinds of average...The harmonic mean can be expressed as the reciprocal of the arithmetic mean of the reciprocals of the given set of observations.

To translate that bewildering language into the 3-step recipe via which an egregiously high P/E ratio is cleansed into a harmless middling sort of group average, observe the following hypothetical portfolio consisting of a range of low, somewhat high and egregiously high-valuations. In fact, if you ponder Stock D’s treatment, the higher the true P/E, the less and less it counts in the average.

<table>
<thead>
<tr>
<th>Stock</th>
<th>P/E Ratio</th>
<th>Step 1: Reciprocal of the P/E Ratios</th>
<th>Step 3: Reciprocal of the Step 2 average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock A</td>
<td>10</td>
<td>1/10 = 0.10</td>
<td></td>
</tr>
<tr>
<td>Stock B</td>
<td>20</td>
<td>1/20 = 0.05</td>
<td></td>
</tr>
<tr>
<td>Stock C</td>
<td>30</td>
<td>1/30 = 0.033</td>
<td></td>
</tr>
<tr>
<td>Stock D</td>
<td>300</td>
<td>1/300 = 0.0033</td>
<td></td>
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<tr>
<td>Average P/E:</td>
<td>90x</td>
<td>Sum = 0.1867</td>
<td>0.1867/4 = 0.0465 = 21.5x</td>
</tr>
</tbody>
</table>

Incidentally, a simple average of the P/E ratios of the 91 profitable companies in the NASDAQ 100, results in a valuation of 43.6x earnings. Or, if one calculated the weighted average P/E ratios of the 91 profitable companies (giving proportionately greater weight to the larger companies), then the QQQ valuation is 41.0x. No active manager would be permitted to manage a concentrated, high-P/E portfolio for an institutional client. Only an index enjoys this privilege.
Can One Hide From The NASDAQ 100 In The S&P 500?

This is a degree of narrowness that is very un-indexlike.

<table>
<thead>
<tr>
<th>Company</th>
<th>Index Weight</th>
<th>YTD Return (6/30/2017)</th>
<th>Contribution to S&amp;P 500 return</th>
<th>% Contribution to Total Index Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amazon</td>
<td>1.85%</td>
<td>29.1%</td>
<td>0.45%</td>
<td>4.82%</td>
</tr>
<tr>
<td>Facebook</td>
<td>1.72%</td>
<td>31.2%</td>
<td>0.44%</td>
<td>4.71%</td>
</tr>
<tr>
<td>Microsoft</td>
<td>2.56%</td>
<td>12.2%</td>
<td>0.30%</td>
<td>3.21%</td>
</tr>
<tr>
<td>Apple</td>
<td>3.61%</td>
<td>25.4%</td>
<td>0.82%</td>
<td>8.78%</td>
</tr>
<tr>
<td>Alphabet Inc. Class A</td>
<td>1.33%</td>
<td>17.3%</td>
<td>0.21%</td>
<td>2.25%</td>
</tr>
<tr>
<td>Alphabet Inc. Class C</td>
<td>1.30%</td>
<td>17.7%</td>
<td>0.21%</td>
<td>2.25%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>12.37%</strong></td>
<td><strong>2.43%</strong></td>
<td><strong>26.02%</strong></td>
<td></td>
</tr>
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Worded differently, a manager/analyst who was so brilliant as to have a stock selection error ratio of merely 1.00%, by not owning these 5 of the 500 stocks, would have underperformed by over a quarter of the S&P 500 return.

In 2015, the 10 best performing stocks in the S&P 500, 2% of the holdings, accounted for more than 100% of the return that year. They included Amazon, Microsoft, Google, Facebook and Netflix.

In 2016, 5% of the S&P 500 companies accounted for 50% of the index return. Failure to own those 25-odd names, and a manager would have underperformed by nearly 600 basis points. Among, them, Amazon, Microsoft, Apple and Facebook.

To outperform, it would been insufficient to have owned each and every one of these companies that (excepting Apple) trade at extremely high P/E ratios, valuations that could contract at any moment for any number of reasons. One would have had to own not only the full positions, but have overweighted them. One would have to take that further risk as well.

Source: Bloomberg
Right on Schedule: Google + Facebook Versus AOL

18 Years and Counting

The valuation risk imponderables are:
(1) the maximum share of advertising revenue these firms can achieve;
(2) the time at which the maximum share will be reached;
(3) the P/E at the time that Google and Facebook absolutely dominate advertising; and
(4) whether there will be a cyclical decline in advertising expenditure that will disrupt the growth of these firms, and if so, when it might occur.

It is a very dangerous game to play. In January 2000, within a few inches of the tech bubble peak, AOL and Time Warner agreed to merge. The aftermath was one of the greatest cases of buyer’s regret in stock market history.

It wasn’t so much the matter of the AOL Time Warner stock dropping 90%, but that it was 90% of a $350 billion combined stock market capitalization at the time of the merger agreement.

<table>
<thead>
<tr>
<th>2017 Internet-Related Advertising</th>
<th>($ in billions)</th>
</tr>
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<tbody>
<tr>
<td>Mobile Internet</td>
<td>$114</td>
</tr>
<tr>
<td>Desktop Internet</td>
<td>114</td>
</tr>
<tr>
<td>Total</td>
<td>$228</td>
</tr>
<tr>
<td>Facebook &amp; Google</td>
<td>$140</td>
</tr>
<tr>
<td>As % of World Internet Advertising</td>
<td>61.4%</td>
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</tbody>
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<table>
<thead>
<tr>
<th>Projected Global Advertising Expenditures in 2020</th>
<th>($ in billions)</th>
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<tbody>
<tr>
<td>Facebook &amp; Google, at 25%/yr growth</td>
<td>$273</td>
</tr>
<tr>
<td>Global advertising, at 4%/yr growth</td>
<td>677</td>
</tr>
<tr>
<td>Facebook &amp; Google, as % of Worldwide Advertising</td>
<td>40.3%</td>
</tr>
</tbody>
</table>

Source: Zenith Optimedia
The Internet: A Study in Reason and Unreason

(1) The Ultimate Internet Market in a Perfect AOL Future
World population: 6 billion inhabitants
Internet households: 1.5 billion, including the homeless
and Third World homes without electricity or computers
Market share: 100%
Monthly household internet expense: $20/month,
including the indigent worldwide
Revenue/year: $360 billion
Operating margin: 50%, exceeding that of Microsoft
Net profit after tax: $117 billion

(2) The Terminal Internet Equity Valuation
In the presupposed market saturation environment, it is by
definition a zero growth environment, which would
logically impose low valuations. However, in the interest
of maintaining an bullish scenario, we can assume a
typical Internet company valuation of 30x earnings, which
would be $3.51 trillion.

(3) The Question of Time, Market Share and Other Factors
The time value of money is a powerful influence upon
valuation. We will assume complete global usage by
individuals of the Internet will be achieved in 20 years; 30
years would markedly reduce the rate of return. Also
critical: market share, profit margin, and the final
valuation multiple.

(4) The Question of Returns to Investors
Current AOL market cap: $140 billion
Terminal Internet Industry mkt. cap: $3.51 trillion in 20 years
Return to investors: 17.5%/year (at 100% market share)
Return to investors: -11.2%/year (at the current 33% share)

(5) The Question of Sensitivity
Assuming a more reasonable
10% profit margin, net profit after tax is
at $36 billion.

(6) The Question of Competition
All of the preceding computations assume that
AOL will be an Internet Service Provider monopoly
in 20 years, which is a highly unlikely event.

Source: Horizon Kinetics Research
### Texas Pacific Land Trust – An Alternative Correlation

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</tr>
</thead>
<tbody>
<tr>
<td><strong>Oil &amp; gas royalties</strong></td>
<td>205%</td>
<td>$44.8</td>
<td>$22.4</td>
<td>$30.0</td>
<td>$24.9</td>
<td>$29.3</td>
<td>$24.5</td>
<td>$14.7</td>
</tr>
<tr>
<td><strong>Easement income</strong></td>
<td>373%</td>
<td>51.6*</td>
<td>24.4</td>
<td>26.5</td>
<td>31.4</td>
<td>21.5</td>
<td>12.2</td>
<td>10.9</td>
</tr>
<tr>
<td></td>
<td>276%</td>
<td>$96.4</td>
<td>$46.8</td>
<td>$56.5</td>
<td>$56.3</td>
<td>$50.8</td>
<td>$36.7</td>
<td>$25.6</td>
</tr>
<tr>
<td><strong>Oil prices</strong>*</td>
<td></td>
<td>$50.54</td>
<td></td>
<td>$53.75</td>
<td>$36.59</td>
<td>$54.14</td>
<td>$98.17</td>
<td>$91.83</td>
</tr>
<tr>
<td><strong>TPL revenues, % change</strong></td>
<td>276%</td>
<td>106%</td>
<td></td>
<td>$47%</td>
<td>(32%)</td>
<td>(45%)</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td><strong>Oil price, % change</strong></td>
<td>(45%)</td>
<td></td>
<td></td>
<td>1%</td>
<td>11%</td>
<td>38%</td>
<td>43%</td>
<td></td>
</tr>
</tbody>
</table>

* Does not include deferred revenue accounting adjustment; cash-basis easement income would be $78.8MM

** Using 1st quarter, 2017 run-rate results

*** West Texas Intermediate, year-end p, Federal Reserve Bank of St. Louis

Last month, the Trust filed a two-paragraph announcement. It has created a subsidiary called Texas Pacific Water Resources LLC. The intent is to provide water-related services to companies engaged in oil drilling activities in the Permian Basin. These would include water sourcing, treatment and recycling, as well as associated infrastructure construction, disposal and even well testing services. These water costs are so high, that it has become one of the critical variables in determining the economics of drilling in this area.

This is an entirely new business and source of value for the Trust, and one that has the possibility to be conducted on a large scale. An essential asset underlying this venture is the Trust’s 800,000+ surface acres of land, the Trust being one of the largest private landowners in Texas. This asset includes something very valuable in the southwest U.S.: water rights. It does not, as yet, produce any revenues; it is a classic example of a dormant or hidden asset.

Source: Company reports, Horizon Kinetics Research
True High Yield Investing: What we Sold and Why

Atwood Oceanics 6.5% Senior Note due February 2020

**The Business:** Atwood is one of only several global-scope companies that provide ultra-deep-water and harsh environment offshore drilling services to customers like Chevron and Shell. Although it was still profitable, most of its contracts were going to expire in the coming two years. If not renewed or replaced, the company would lose most of its revenues. It had long-term debt of $1.61 billion, but this amounted to less than 40% of its property and equipment of $4.21 billion. Moreover, its most valuable vessels, its drillships, were unencumbered.

**The Risk (or Margin of Safety) Profile:** At the time we purchased the bonds in early 2016, the Atwood common shares had dropped by more than 80% from their mid-2014 high, due to the steep 18-month drop in oil prices. However, a bond has powerful legal claims on earnings and assets that supersede the rights of any common stockholder, irrespective of the credit rating. Because of that, in certain situations a bond can offer safety and return properties that are difficult to imagine being available from any stock, no matter how robust the company.

With $1.61 billion of debt, Atwood’s property and equipment would have to be sold for less than 40% of its $4.21 billion book value before its debt would be worth less than face value. The margin of safety was greater still, because the average price we paid for the bonds was not face value, but roughly 56¢ on the dollar, or 44% below face value. Ergo, if the operating assets would be written down by 50%, and if the company’s bank debt (with senior claim to repayment) were then paid in full, the remaining liquidation value of the assets would still exceed the cost of the bonds by 60%—meaning that even under that scenario the bonds would be still be paid off at face value. That can’t be done with a common stock. Moreover, 2 years of coupon payments would provide another 13% points of safety.

**The Expected Return Profile:** The appreciation to face value of 100, from the purchase cost of 56, would be 78%. Realized over the four years until maturity, that would be about 15.6% per year. But there was also the 6.5% coupon; purchased at 56¢ of face value, that would provide an 11.6% yield, for an expected total return of roughly 27% per year. As it transpired, oil prices did not remain at the $25 to $30 per barrel lows, and we sold the Atwood bonds this past month at an average price of about $99 after Ensco PLC agreed to acquire the company. The roughly one-year return was about 88%. The Atwood common stock is lower today than in early 2016.

**Whiting Petroleum 5% Senior Notes,** also sold during the quarter, were a substantially similar investment.

Source: Company reports, Horizon Kinetics Research
True High Yield Investing: What we Bought

Cheniere Energy 4.25% Convertible Notes due 2045

**The Business:** LNG is produced by purifying and cooling natural gas to -260°F, which reduces its volume to 1/600th of its gaseous state, and at close to atmospheric pressure. That permits it to be transported cheaply in the absence of pipelines, and U.S. LNG has a distinct price advantage on the world market. Cheniere started construction of its facilities several years ahead of competitors, and no other company yet exports LNG. At its two Gulf Coast terminals, Cheniere is on schedule and on budget to operate a total of 5 modules, or trains, by end of 2019, and an additional two in future years. Each train consists of an LNG liquefaction and purification facility.

The unusual, perhaps unique, business attribute of Cheniere is that even before it had shipped its first cargo, in early 2016, about 87% of its future capacity from the first 7 trains had already been sold. These were done under 20-year contracts, with estimated annual fixed fees of $4.3 billion. These “take or pay” fixed fees are guaranteed by the parent entity of each customer – all global, investment grade companies – and are payable whether or not the terminals are used. Of course, the plants had yet to be completed and the shipments and revenue yet to be forthcoming.

**The Risk Profile:** Cheniere had $16.2 billion of property, plant and equipment at the end of 2015, of which almost 90% was classified as construction in progress. Accordingly, it also had $15.1 billion of long term debt, and $322 million of annual interest expense. It had only $1.6 billion of shareholders’ equity after having lost, for the year, $1 billion. Accordingly, the common share price was down 70% from a year and a half earlier, and the bonds, which were not rated, traded at around 50¢. By the end of 2016, though, 56 cargoes of LNG had been shipped to 17 different countries. At the time of our first bond purchases, despite the fact that Cheniere had only just transitioned from development stage to, with its first shipload of LNG, being an operating company, its 20-years of pre-sold capacity conferred a degree of assuredness as to essential profitability and safety that is rarely to be found.

But not necessarily for the equity. The fundamental financial safety of the common shares is entirely subordinate to the $16 billion of Cheniere debt. Yet, if the company’s business does become robust, there is also the possibility for these bonds to be converted into the common. The shares would have to rise to $138 before the convertibility would increase the value of the bonds above 100. So this would have to be considered a deep out-of-the-money call option. On the other hand, it’s a call option that gives you 28 years of opportunity to participate in the LNG market, if indeed the LNG market grows as much as one might hope.

Source: Company reports, Horizon Kinetics Research
Let's first review some interesting growth statistics about a slightly different company that is necessary to understanding Liberty Sirius XM:

- Revenues have been rising at a 10.1% annualized rate for the past 5 years.
- It benefits from scale economies, as evidenced by an operating margin that has expanded from 22.4% to 28.5% in 2016, and even more in the first quarter of 2017. The company believes its margins can expand by another 4% points in the coming years.
- As a result, net income over the five years has increased by 11.8% a year.
- More impressive, unlike most companies, its after-tax free cash flow, after making capital expenditures, is much higher than its net income, and has increased by 18.6% a year. Cumulative free cash flow over those five years was $4.9 billion.
- Of the same rank of impressiveness this company has reduced its share count by 24% over the last four calendar years, repurchasing $7.95 billion of stock.
- As a beneficial consequence of shrinking the share base, all of the above earnings figures are far higher in the way that it counts: on an annualized per-share basis. Per-share, revenues are up 16.9% a year, net income 18%, and free cash flow 25%.
- The free cash flow margin is 23% of revenues, which is strikingly high. As a high-end basis of comparison, Microsoft, has a 20% net profit margin, also strikingly high, but its free cash flow margin, after capital expenditures, is 11%.
- Part of the reason the free cash flow is so high is that the company pays no federal income taxes, due to its $1.4 billion of net operating loss carryforwards and tax credits. At the state level, it did pay $21 million in 2016, $12 million the year before, $9 million the year before that.
- And the reason for that, in large measure, is that the company is controlled by John Malone.
The preceding company discussed is called Sirius XM Holdings Inc. (Sirius), and it is the provider of the dominant subscription based satellite radio service, the equipment for which is installed in 75% of new cars in the U.S. This is a highly profitable and growing business.

Over 67% of the Sirius shares are held by the entity that we do own in accounts, known as The Liberty Sirius XM Group. Accordingly, Sirius’s freely tradeable shares—its float—are fairly limited. And although investors typically assign a premium to companies that might be takeover targets, as an independent Sirius certainly would be, Sirius can’t be acquired, since it is controlled by Liberty Sirius. So, it is that much less exciting to the short-term investor than it otherwise would be.

As to valuation, Sirius trades at 21.96x our calculation of its trailing free cash flow, net of capital expenditures, which is a far more conservative than both the company’s calculation of free cash flow and than net income or the P/E ratio; most companies’ free cash flow is far lower than earnings. And 21.96x is almost precisely the P/E ratio of the S&P 500. And while that is hardly a low valuation, the Sirius growth rate far exceeds that of the S&P 500. Moreover, if Sirius can indeed increase its operating margins by 4% points over the next few years, and allowing for only 5% revenue growth, which is one-half the historical 10% experience, then the current price is equivalent to less than 13x the free cash flow the company is likely to generate in 2020. Nor does that include the beneficial impact upon per-share value of continued share repurchases. In this year’s first quarter, the company repurchased another $306 million worth of shares.

As well, we own Sirius at a discount—through Liberty Sirius. Liberty Sirius has a stock market capitalization of $14 billion. Its only asset is the shares it holds of Sirius, and so Liberty Sirius can be valued like a fund with a net asset value. In this case, the net asset value is simply the market value of the Sirius shares, less the Liberty Sirius debt. And the Liberty Sirius shares trade at about a 20% discount to that NAV, which would be roughly 18x trailing free cash flow.

Source: Company reports, Horizon Kinetics Research
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